

SECTION 1: THE STATUS OF CHINA'S COMPLIANCE WITH ITS WORLD TRADE ORGANIZATION OBLIGATIONS AND THE IMPACT OF CHINA'S INDUSTRIAL SUBSIDIES ON U.S. AND OTHER MARKETS

The Commission shall investigate and report on "WORLD TRADE ORGANIZATION COMPLIANCE—The compliance of the People's Republic of China with its accession agreement to the World Trade Organization."

Key Findings

- China's adherence to its many World Trade Organization (WTO) obligations remains spotty and halting in important areas five years after China attained membership. As a result, U.S. exporters and investors face a variety of non-tariff barriers and major impediments to conducting business in China. In some areas, such as banking reform, China has made progress. But in too many cases, the government has delayed and even backtracked on its obligations.
- China "has not yet fully embraced the key WTO principles of market access, non-discrimination, and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent ... [and China] continues to use an array of industrial policy tools ... to promote or protect favored sectors and industries," according to the U.S. Trade Representative.¹¹
- China's failure to enforce intellectual property rights provides a particularly egregious example of its noncompliance with WTO rules. China's refusal to protect copyrights, inventions, brands, and trade secrets has placed it first among nations on the U.S. Trade Representative's "priority watch list" of countries that tolerate intellectual piracy.¹²
- China has a centralized industrial policy that employs a wide variety of tools to promote favored industries. In particular, China has used a range of subsidies to encourage the manufacture of goods meant for export over the manufacture of goods meant for domestic consumption, and to secure foreign investment in the manufacturing sector.
- China artificially lowers the value of its currency to maintain an export-led trade policy. The State Administration for Foreign Exchange accomplishes this by buying dollars and other foreign currency in China at a fixed rate of around 8 renminbi to the dollar. Only small fluctuations in the value of the renminbi are allowed.
- At times, China's central government and governing bodies in the provinces and localities appear to be operating at cross purposes. Decisions by the central government meant to comply with WTO rules sometimes are ignored in the provinces. Regulations established by Beijing are not necessarily enforced elsewhere.

Overview

China spent 15 years negotiating the terms of its accession to membership in the General Agreement on Tariffs and Trade (GATT) and its successor organization, the WTO.¹³ Despite the fact that China was officially designated a “non-market economy,” it was admitted to WTO membership in December 2001.¹⁴ Among the motivations for the United States and other nations to approve its accession was the idea this would encourage continued economic policy reform in China. In conjunction with China’s WTO accession, Congress granted Most Favored Nation trading status to China on a permanent basis, ending the preceding practice of annual Congressional review of China’s trade and human rights practices. Proponents of normalizing trade relations with China and allowing it into the now-149-member WTO argued at the time that accepting a country whose market mechanisms were so primitive and whose economy was still centrally controlled by a Communist dictatorship would accelerate economic liberalization. They noted that China’s leadership had openly acknowledged since 1978 that economic reform was required to bring prosperity to a nation impoverished by clumsy central planning. Opponents of China’s WTO admission countered that allowing entry to a country whose institutions and practices were so far removed from market-oriented, free-trade principles would cause large disruptions and imbalances in international trade and result in U.S. job loss.

Today, both sides can point to evidence to support their views. On the positive side, China has sustained a Gross Domestic Product (GDP) growth rate of over nine percent since its admission to the WTO. The proportion of China’s population living below the extreme poverty line—\$2 per day—fell from nearly 73 percent in 1990 to 32 percent in 2003. Meanwhile, the sector of the economy represented by private enterprise expanded to the point that it now produces nearly 60 percent of China’s GDP.¹⁵ In marked contrast to other Asian nations such as Japan and India, China has generally welcomed foreign direct investment and has encouraged joint ventures with Chinese companies. In parts of the services sector, China appears committed to allowing foreign investment as a way of acquiring and applying the management expertise of foreign companies. For example, China opened the domestic currency trade in several cities to foreign banks ahead of schedule.¹⁶ The United States and China agreed in 2004 to substantially increase direct air services between the two nations over the next six years, including both passenger and cargo services. In addition, China has reduced tariff rates on many products on schedule and reduced the number of import quotas in addition to expanding trading rights.¹⁷ China also has granted distribution rights to foreign companies, thereby allowing their products to be sold directly to consumers. China is now America’s second largest market for aircraft exports and the tenth largest market for services exports, according to figures compiled by the U.S. Trade Representative.¹⁸ Beijing also has also made laudable efforts to educate its business leaders and its citizens in the intricacies of WTO regulations and requirements, distributing written guidelines and offering seminars on the new requirements.

But China also has missed many opportunities to comply with both the letter and the spirit of the WTO rules and with its own agreement to phase-in market-oriented reforms. In terms of economic reform, China has essentially gathered the “low-hanging fruit” and must now undertake the more difficult challenges.¹⁹ As the U.S. Trade Representative has said, China “has not yet fully embraced the key WTO principles of market access, non-discrimination, and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent ... [and China] continues to use an array of industrial policy tools ... to promote or protect favored sectors and industries.”²⁰

While an increasing proportion of the economy is private—perhaps 60 percent of GDP is produced by private sector sources—Beijing still wields a heavy hand in planning the overall economy, particularly when it comes to promoting an export-based growth strategy. The Chinese State Council presents a Five-Year Plan that sets forth the economic and development priorities for the coming years. The 2006-2010 period will be governed by the eleventh Five-Year Plan that denotes specific industries to be promoted. These include integrated circuits and software, next-generation network technology, biomedical technology, civilian aircraft, satellite applications, and equipment manufacturing industries, including clean power generation equipment, rail transportation equipment, and machine tools.²¹ To encourage domestically-owned firms to move up the value-added chain, China currently is encouraging investment in high technology-based manufacturing and uses “guidance” as well as trade policy instruments for this purpose.²² These capital goods industries are currently dominated by the United States and other technologically advanced nations and are considered the crown jewels of exports.

Beijing employs such administrative “guidance” to banks to direct loans and favorable terms to certain businesses and industries. China’s tax system encourages foreign direct investment by applying 15 percent and 24 percent income tax rates to foreign-based affiliates operating in China while requiring domestic companies to pay a 33 percent tax rate. Government at all levels can use tax breaks to lure investments. The result is an allocation of resources in favor of manufacturing and export-oriented business.²³

Manufacturing, especially export-oriented manufacturing, has developed more rapidly than other sectors as a result of such government incentives. According to the WTO’s analysis, this segment of industry, which includes manufacturing, mining, and production and supply of electricity, gas, and water, accounted for over 40 percent of GDP in 2005. Manufacturing, much of which is dominated by foreign-invested enterprises, now accounts for over 90 percent of China’s merchandise exports. Foreign-invested enterprises appear also to account for a greater share of the output of higher value-added production.

Enforcing China’s WTO Compliance

The WTO conducts studies of compliance with its rules. Organizations such as the U.S. Chamber of Commerce, the International Intellectual Property Alliance, the National Association of Manu-

facturers, and the U.S.-China Business Council also analyze compliance with WTO rules, and report findings to a federal inter-agency group in Washington, the Trade Policy Staff Committee, which produces an annual evaluation of China's WTO compliance that is published by the U.S. Trade Representative. These studies help focus attention on unfair trade practices by pointing out apparent violations of trade laws.

The WTO process favors negotiation over confrontation, a fact embodied in the language of the process, which references "dispute settlement panels" rather than "courts." The first step of the process requires the two sides in a dispute to meet to settle their differences. Only then can a formal complaint be brought to the WTO. Even then, either party can initially block the formation of a three-judge panel to hear a case. The adjudicative phase of a WTO complaint occurs only after mandatory "consultations" among the parties have failed to reach a compromise. Deliberations of the panels, the second step in the process, are secret and the decision is given to the parties for a 30-day comment period before being released to the public. The intent of every stage of the process is to encourage the parties to settle amicably. In fact, in response to a WTO complaint by the United States over China's treatment of U.S. semiconductors, China and the United States quickly reached a settlement. The two countries should view the entire process as one of encouraging needed reform and bringing fairness to trade.

Centrally Planned Subsidies

In its WTO accession agreement, China agreed to eliminate certain government subsidies meant to encourage exports—specifically, tax incentives and preferential bank financing restricted to producers who agree to export their products. China also pledged to end government programs that encourage local sourcing for parts instead of using imported parts.²⁴ But since joining the WTO, China has increased the use of such export subsidies.²⁵ In both its December 2005 Report to Congress on China's WTO Compliance and its February 2006 Top-to-Bottom Review of U.S.-China Trade Relations, the U.S. Trade Representative has detailed China's efforts to protect domestic producers:

"Since acceding to the WTO, China has increasingly resorted to industrial policies that limit market access by non-Chinese origin goods or bring substantial government resources to support increased exports . . . In 2005, examples of these industries are already evident. They include the issuance of regulations on auto parts tariffs that serve to prolong prohibited local content requirements for motor vehicles, the telecommunications regulator's interference in commercial negotiations over royalty payments to intellectual property rights holders in the area of 3G standards, the pursuit of unique national standards in many areas of high technology that could lead to the extraction of technology or intellectual property from foreign rights-holders, draft government procurement regulations mandating purchases of Chinese-produced software, a new steel industry, continuing export restrictions on coke, and excessive government subsidization benefiting a range of domestic indus-

*tries in China. Some of these policies appear to conflict with China's WTO commitments in the areas of market access, national treatment and technology transfer, among others."*²⁶

According to Loren Yager, Director for International Trade at the Government Accountability Office, "Chinese subsidies remain very difficult to identify and quantify, largely because of the structure of the Chinese economy and the lack of transparency in the country's subsidy regime."²⁷ However, there are a plethora of practices that act as indirect subsidies: preferential tax policies, government funds for state-owned enterprises, double bookkeeping by such enterprises, subsidized inputs for such enterprises, "give-away" prices on energy and land, sectoral credit allocation, loan extensions, debt forgiveness, wage ceilings, and the undervalued renminbi.

The result of subsidies intended to attract factories from abroad and boost China's production of goods for export can be seen easily in three key 2005 economic statistics. Foreign-funded firms²⁸ in China produced 58 percent of China's exports in 2005.²⁹ Seventy-one percent of the \$60.6 billion in foreign direct investments in 2004 went to the manufacturing sector.³⁰ Manufactured goods accounted for 94 percent of China's exports.³¹ China's industrial policy directly harms U.S. manufacturers and results in the loss of U.S. manufacturing jobs.

For example, China subsidizes its steel industry by 1) transferring facilities and land at below market prices; 2) providing debt-to-equity swaps through state-owned banks; 3) providing debt forgiveness through state-owned banks; 4) providing tax benefits for export performance; 5) controlling the prices of raw materials; and 6) maintaining an undervalued renminbi. Subsidies such as tax benefits based on export performance are clearly prohibited by WTO rules. By intervention in the steel industry, the Chinese government has created substantial excess capacity and "has skewed the entire world market for steel and for steel raw material."³²

Many subsidies in China are distributed through China's banking system to state-owned institutions. Not all loans to state-owned enterprises fall into default and not every loan is forgiven rather than repaid. But a significant portion of these loans eventually is written off, constituting an unwarranted subsidy. Standard & Poor's estimates China's delinquent loans total approximately \$600 billion.³³ In the past, this credit was provided from government funds to the state-run economic sector to fund pensions and other employment-related expenses. Now, the funds are mainly used to pay for "extravagant real estate projects" and a general "over-investment in fixed assets."³⁴

China's low wage rates due to unpaid, underpaid, and repressed labor constitute another indirect subsidy to Chinese producers, including domestic, joint venture, and foreign-funded companies. Chinese official sources report over 100 billion renminbi (\$12.6 million) in unpaid wages, 70 percent of which are in the construction sector.³⁵ China has not ratified four of eight core International Labor Organization Conventions. Those not ratified concern the right to organize and collectively bargain and the abolition of forced labor.³⁶ By refusing to accept the responsibilities that other WTO members accept for their workers, the Chinese government countenances low

compensation of labor in violation of international standards, essentially subsidizing those firms that take advantage of this Chinese laxity.